New or Used? Investment with Credit Constraints*†

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Abstract

This paper studies the choice between investment in new and used capital. We argue that used capital inherently relaxes credit constraints and thus firms which are credit constrained invest in used capital. Used capital is cheap relative to new capital in terms of its purchase price but requires substantial maintenance payments later on. The timing of these investment cash outflows makes used capital attractive for credit constrained firms. While used capital is expensive when evaluated using the discount factor of an agent with a high level of internal funds, it is relatively cheap when evaluated from the vantage point of a credit constrained agent with few internal funds. We provide an overlapping generations model and determine the price of used capital in equilibrium. Agents with less internal funds are more credit constrained, invest in used capital, and start smaller firms. Empirically, we find that the fraction of investment in used capital is substantially higher for small firms and varies significantly with measures of financial constraints with the predicted sign.

JEL Classification: D92; E22; G31.

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